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DEFERRED CASH PAYMENTS TO SECURED CREDITORS IN CRAM DOWN OF CHAPTER 11 PLANS: A MATTER OF INTEREST

What is the present value of deferred payments made to secured creditors under a Chapter 11¹ reorganization plan? Courts agree that the present value depends on the interest rate that is used to compute the payments' value.² They cannot agree, however, on how the proper interest rate should be determined.³

In their attempts to set a proper interest rate, most courts travel down the dead-end road of market rate analysis. Boggled down in the intricacies of this analysis, courts frequently ignore their fundamental role in bankruptcy proceedings: Resolving the tension between giving creditors protection while giving debtors a chance to save their businesses. Examinations of economic data and theories preoccupy the courts as well as creditors and debtors. This effort to determine the proper interest rate takes place in a vacuum, cut off from considerations of creditors' and debtors' rights and the bankruptcy system's purposes.

The method used by courts for setting interest rates in business reorganization cases should be reevaluated. Instead of case-by-case determinations, courts could use, in all cases, Treasury securities yields of an appropriate maturity. With these relatively low interest rates, more reorganizations will be feasible. Low rates will also increase the chance of preserving the economic viability of the debtor and insure continuing employment. In addition, treasury rates are accessible, making expensive litigation unnecessary and saving the debtor's assets for distribution among creditors. Loan markets can adapt to the standard. Finally, creditors can protect themselves from the risk of loss from Chapter 11 proceedings by slightly raising contract interest rates. A single, clear standard for interest rate determination will decrease the tension between creditors' and debtors' interests in the bankruptcy process.

I. THE PIVOTAL ROLE OF THE INTEREST RATE LEVEL

Interest required on deferred payments can determine the success or failure of the debtor's reorganization plan. Not surprisingly, the issue

1. 11 U.S.C. §§ 1101-1174 (1982 & Supp. IV 1986).

2. *In re Southern States Motor Inns*, 709 F.2d 647, 650 (11th Cir. 1983), *cert. denied*, 465 U.S. 1022 (1984).

3. *Id.* at 651.

is hotly contested between debtors and secured creditors. Courts are often asked to resolve the dispute. In setting an interest rate, courts not only resolve a particular dispute about the proper interest rate. They also define the purposes of the bankruptcy system, the rights of debtors and creditors in Chapter 11, and their respective bargaining power in Chapter 11 reorganization plan negotiations.

A. Chapter 11 Cram Down and Deferred Payments

A Chapter 11 reorganization plan restructures the debtor's obligations, usually to decrease immediate cash flow problems⁴ by extending the time period for payment. In general, a court must deny confirmation of the plan if any affected class of creditors rejects the plan.⁵ If a class rejects a plan, however, the debtor can request confirmation under 11 U.S.C. § 1129(b).⁶ If the plan complies with 11 U.S.C. § 1129(b) and eleven other requirements,⁷ the court must confirm the reorganization plan.

To achieve confirmation despite rejection by a class of secured creditors, the plan must be "fair and equitable" and not "discriminate unfairly" among holders of similar claims.⁸ A plan can be fair and equitable if it meets one of three alternative minimum requirements.⁹ The first requirement mandates that the creditor retain the lien secur-

4. See Klee, *All You Ever Wanted To Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133 (1979), reprinted in 1981 ANN. SURV. BANKR. L. 201, 201 (1981) (all subsequent references are to the page number in the reprinted version of the article).

5. 11 U.S.C. § 1129(a)(8) (1982 & Supp. IV 1986). A class of creditors fails to accept the plan if one-half or more of the creditors holding more than one-third in amount of claims reject it. 11 U.S.C. § 1126(c) (1982). If collateral secures the claim, it is unique and usually in a class by itself. A single secured creditor therefore can "veto" the proposed plan.

6. 11 U.S.C. § 1129(b) (1982 & Supp. IV 1986). The process of plan confirmation despite rejection by a class of creditors is called "cram down." See H.R. REP. NO. 595, 95th Cong., 1st Sess. 413 [hereinafter HOUSE REPORT], reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6369.

7. 11 U.S.C. § 1129(a) (1982 & Supp. IV 1986). Both the plan and the proponent of the plan have to comply with the provisions of Chapter 11 and the plan must be proposed in good faith. § 1129(a)(1)-(3). Payments in connection with the case must be subject to court approval and certain appointments and treatment of insiders must be disclosed. § 1129(a)(4), (5). Any government regulatory commission with jurisdiction over the debtor's rates must have approved rate changes. § 1129(a)(6). A dissenting member of a class that has accepted the plan must receive at least what Chapter 7 liquidation would have provided. § 1129(a)(7). Certain priority claims have to be paid on the effective date of the plan and tax claims have to be paid over a period not exceeding six years. § 1129(a)(9). At least one impaired class must accept the plan. § 1129(a)(10). The plan must be feasible. § 1129(a)(11). All fees payable under § 1930 of title 28 will be paid on the effective date of the plan. § 1129(a)(12).

8. 11 U.S.C. § 1129(b)(1) (1982). The requirement that the plan not unfairly discriminate among holders of similar claims is usually met with respect to a class of secured creditors because they do not hold similar claims.

9. 11 U.S.C. § 1129(b)(2) (1982 & Supp. IV 1986).

ing its claim and receive deferred cash payments with a present value that is equal to the secured claim's value.¹⁰ The analysis of this Comment focuses on that method of meeting the fair and equitable test of Chapter 11 cram down.

B. The Courts' Role in the Dispute Between Debtor and Creditor

Courts, debtors, and creditors agree that the "fair and equitable" test requires that some interest be paid on deferred cash payments.¹¹ The legislative history of the Bankruptcy Reform Act of 1978 (the "Code")¹² explicitly refers to interest.¹³ The legislative history is silent, however, on the method of determining the appropriate interest rate. Debtor and creditor, unable to agree on the interest rate, bring this question to the court for resolution.

When a court is asked to apply the 'cram down provisions to a secured creditor, it is dealing with an unusual Chapter 11 proceeding.¹⁴ The Code was designed to facilitate efficient, fair outcomes with minimal court involvement by balancing the bargaining power of debtor and creditor.¹⁵ In this situation, however, debtor and creditor

10. 11 U.S.C. § 1129(b)(2)(A)(i)(I), (II) (1982 & Supp. IV 1986). This section provides that the creditor has to receive deferred cash payments "totaling at least the allowed amount of [its] claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property." § 1129(b)(2)(A)(i)(II).

The test is also met if the secured creditor realizes the "indubitable equivalent" of its claim. § 1129(b)(2)(A)(iii). The language refers to the approach taken in *In re Murel Holding Corp.*, 75 F.2d 941 (2d Cir. 1935). See S. REP. NO. 989, 95th Cong., 2d Sess. 127, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5913. This section is invoked only if the creditor is to receive property rather than cash. Courts then require that the present value of the property be equal to the value of the claim. This test usually does not focus primarily on the interest rate question. The third alternative permits sale of the collateral as long as the creditor's lien attaches to the proceeds. The creditor then has to receive either deferred cash payments with a present value equal to the allowed claim or the "indubitable equivalent" of its claim. 11 U.S.C. § 1129(b)(2)(A)(ii) (Supp. IV 1986). Under most plans, sale of collateral is not proposed.

11. See, e.g., *In re Smith*, 58 Bankr. 652, 654 (Bankr. W.D. Va. 1985); *In re Connecticut Aerosols*, 42 Bankr. 706, 707 (Bankr. D. Conn. 1984).

12. Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as amended at 11 U.S.C. §§ 101-1330 (1982 & Supp. IV 1986)).

13. HOUSE REPORT, *supra* note 6, at 414-15:

Application of the test . . . requires a valuation of the consideration "as of the effective date of the plan". This contemplates a present value analysis that will discount value to be received in the future; of course, if the interest paid is equivalent to the discount rate used, the present value and face future value will be identical. . . . [I]f no interest is proposed to be paid, the present value will be less than the face future value.

14. See Klee, *supra* note 4, at 201 (debtor and creditors reached an agreement in majority of cases in which plans are confirmed).

15. See, e.g., COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, pt.I at 253-54, [hereinafter COMMISSION REPORT]; reprinted in COLLIER ON BANKRUPTCY, Appendix 2 (L.

were unable to reach the negotiated settlement envisioned by the drafters of the Code.¹⁶

Given the incentive to settle,¹⁷ failure to do so indicates that the parties' dispute involves more than simply setting an interest rate.¹⁸ By setting the interest rate, the court not only decides the interest rate issue, but it vindicates or compromises the positions taken by the parties about their respective rights as debtor and creditor. The court's decision also affects the Code's goal of encouraging negotiated settlements.¹⁹

Courts requiring a high interest rate treat creditor protection as cram down's major purpose. A higher interest rate gives secured creditors greater compensation for the losses and risks associated with the delayed payment of their claims. Higher rates force more conversions to Chapter 7 liquidation,²⁰ allowing secured creditors to take possession of their collateral or of the proceeds of its sale. The threat of higher rates required in cram down increases the secured creditor's bargaining power during negotiations over the reorganization plan.

Courts requiring a low interest rate promote the general purpose of permitting debtors to reorganize. The lower interest payments decrease the burden on the debtor. More plans will be feasible, increasing the chance that businesses and jobs will be preserved. If

King 15th ed. 1979). The Commission criticized the fairness standard of the prior law because old Chapter XI favored the debtor too much and Chapter X hampered negotiations by requiring independent court inquiry into the plan's fairness. *Id.*

16. Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 BUS. LAW. 441, 441 (1984) (Chapter 11 is biased toward settlement).

17. Cram down litigation prolongs the proceedings, is expensive, and removes the determination of the parties' rights from their control. *Cf. Axe, Penetrating the Iron Curtain: Representing Secured Creditors in Chapter 11 Reorganization Proceedings*, 67 MARQ. L. REV. 421, 424 (1984) (debtors elect to forego the uncertainties of cram down); Broude, *supra* note 16, at 441 (possible negative impact of cram down so significant that it represents a threat rather than a "club actually employed").

18. Disputes often involve one or more of the following positions. The creditor is resisting the debtor's attempts to refinance its debts at a lower rate by resorting to Chapter 11's protection. The creditor wants to force liquidation, and other methods, such as requesting conversion to a Chapter 7 liquidation, filing a plan that proposes liquidation, or challenging the debtor's good faith or the plan's feasibility, have failed. Successfully demanding a higher interest rate on deferred payments may achieve the goal if the debtor cannot pay the higher rate. The creditor wants more of the debtor's future income by asking for a higher interest rate. Valuation of the creditor's claim can achieve the same result and may have been decided against the creditor in a separate court ruling. The debtor then resists the creditor's efforts to obtain through the interest rate what was denied by a low valuation of the claim.

19. Klee, *supra* note 4, at 201-02 (cram down rules affect negotiating posture of debtor and creditors, requiring judges, debtor, and creditors to know under what conditions a plan will be confirmed under cram down rules).

20. 11 U.S.C. §§ 701-766 (1982 & Supp. IV 1986).

successful, the reorganization allows unsecured creditors and equity holders to recover funds. Lower rates also make Chapter 11 a more attractive alternative to the debtor that chooses not to pay its debts or simply wants to refinance at lower rates.

Adherence to either interpretation of cram down's role in Chapter 11 is not mandated by the Code. Cram down can also be used to balance the rights of debtor and secured creditor. The court can set the rate according to its assessment of the requirements of fairness and equity.

II. THE COURTS' TREATMENT OF THE INTEREST RATE ISSUE

Concluding that the Code and legislative history do not address the question of the appropriate interest rate, an influential commentator has argued for the use of market interest rates.²¹ Collier views the deferred payment arrangement between creditor and debtor as a "coerced loan."²² According to Collier's theory, loan markets and market interest rates determine the appropriate interest rate.²³ Market rate analysis is now prominent in cases dealing with the deferred payment provisions.²⁴ A discussion of market interest rates provides

21. 5 COLLIER ON BANKRUPTCY ¶ 1129.03, at 1129-62 (L. King 15th ed. 1979).

22. *Id.* at 1129-62 to -63:

It is submitted that deferred payment of an obligation under a plan is a coerced loan and the rate of return with respect to such loan must correspond to the rate which would be charged or obtained by the creditor making a loan to a third party with similar terms, duration, collateral, and risk. It is therefore submitted that the appropriate discount rate must be determined by reference to the "market" interest rate.

(footnote omitted).

As is indicated by this excerpt, the terms "interest" and "discount" rate are prominent in materials related to cram down provisions. When the term "interest" as distinguished from "discount" rate is used, an amount that is earned or added to a certain sum is usually described. For example, at 10% interest per year, \$1000 would earn \$100 *interest* by the end of the year. The reverse procedure is implied by the term "discount" rate. A bond with a face value of \$1000 payable one year from now and selling presently for \$909 has been *discounted* by an annual rate of 10%. See D. PEARCE, *THE DICTIONARY OF MODERN ECONOMICS* 110-11 (2d ed. 1983).

To apply § 1129(b)(2)(A)(i)(II), namely to determine whether the proposed payments, including interest payments, are equal to the value of the collateral, the court must "discount" all future payments by an interest rate it deems appropriate. The present value figure is then compared with the assessed value of the collateral. The court's choice of discount rate does not change the present value of the secured creditor's claim. The collateral's value is determined by a separate valuation procedure. Instead, when the present value of the deferred payments is found not to be equal to the value of the collateral, either proposed principal or interest payments have to be changed.

23. *Id.* Collier presents an extensive table of market rates, noting that a "range of prevailing interest rates" exists at any point in time. *Id.* at n.45.

24. See, e.g., *In re Camino Real Landscape Maintenance Contractors*, 818 F.2d 1503, 1505 (9th Cir. 1987); *United States v. Neal Pharmacal Co.*, 789 F.2d 1283, 1285 (8th Cir. 1986); *In re*

helpful background before summarizing the courts' applications of market rate analysis.

A. Interest Rates

In economics and finance, the term "interest rate" is well defined.²⁵ A nominal²⁶ interest rate has three components: Inflationary expectations, a "real" rate of interest, and certain risk premiums.²⁷ Each of the elements takes into account a separate aspect of the difference between having a certain amount of money now rather than later.²⁸

One component of the nominal interest rate is an estimate of future inflation rates. If inflation occurs while a loan is outstanding, the amount of money lent will have a lower purchasing power when it is repaid. Lenders want to be protected against loss of purchasing power caused by inflation.²⁹ Interest rates reflect the market's expectations about future inflation rates.³⁰

Different inflation rates may be expected for different time periods. The "inflationary expectations" element of interest rates represents the market's³¹ best estimate of future inflation rates over various time periods. Short-term rates³² include inflationary expectations closely tied to actual inflation. Over the short term of the loan, any change in the inflation rate is not expected to result in a significantly different aver-

Monnier Bros. 755 F.2d 1336, 1339 (8th Cir. 1985); *In re Southern States Motor Inns*, 709 F.2d 647, 651 (11th Cir. 1983), *cert. denied*, 465 U.S. 1022 (1984).

25. In economic theory, "interest" means the return earned by capital; in banking and finance, the charge for borrowing money. C. AMMER & D. AMMER, *DICTIONARY OF BUSINESS AND ECONOMICS* 235 (2d ed. 1984).

Collier advocates determining the appropriate interest rate by referring to interest rates prevailing in the market, as opposed to rates set outside the market. Legal interest rates are an example of non-market interest rates. The discussion in this section of the article refers to interest rates set in the market.

26. "Nominal" describes the measurement of an economic magnitude in current prices and denotes the opposite of "real." D. PEARCE, *supra* note 22, at 313; *see also* E. BRIGHAM, *FUNDAMENTALS OF FINANCIAL MANAGEMENT* 60 n.5 (4th ed. 1986).

27. E. BRIGHAM, *supra* note 26, at 60.

28. *Id.* at 79.

29. *Id.* at 61.

30. *Id.*

31. Following convention, the term "market," denoting the singular, is used here. But a credit economy consists of many financial markets. The "inflationary expectations" component will be uniform in all of those markets.

32. Short-term refers to liabilities whose maturities range from a single day up to one year. Interest on loans maturing in more than one year are regarded as long-term rates. C. AMMER & D. AMMER, *supra* note 25, at 423-24.

age inflation rate. Inflationary expectations reflected in longer term rates are more likely to vary from current inflation rates.³³

The “real” interest rate is the price required to induce a lender to effect an exchange between current and future consumption.³⁴ The “real” interest rate is determined by the supply and demand of funds, which in turn is affected by time preference, time endowment, and time productivity.³⁵ Preferences and endowment tend to be stable, though recessions and booms, reflecting expected changes in productivity, may temporarily influence the real interest rate.³⁶ The real interest rate component is estimated to fluctuate between 2% and 4%.³⁷

Inflationary expectations and the real rate of interest are the same for all borrowers. The risk premium accounts for differences in interest rates obtained by individual borrowers in the market.³⁸ Interest rates on loans considered low-risk are lower than interest rates on

33. Professor Brigham presents the results of a University of Michigan Survey Research Center study. It reported inflationary expectations of 4% for 1983 and 6% to 7% for the following five to ten years. E. BRIGHAM, *supra* note 26, at 62 n.6. The Consumer Price Index (CPI), “All Items,” during 1983 increased by 3.8%; very close to the expected rate. PRESIDENT OF THE UNITED STATES, ECONOMIC REPORT OF THE PRESIDENT, Table B-59 (1987) [hereinafter ECONOMIC REPORT].

34. E. BRIGHAM, *supra* note 26, at 61; J. HIRSHLEIFER, PRICE THEORY AND APPLICATIONS 415 (1976).

35. J. HIRSHLEIFER, *supra* note 34, at 430–32. The time at which consumption is preferred, whether currently or in the future, is called time preference. *Id.* at 431. Preference for current consumption increases the demand for loans and hence increases interest rates. For example, differences in the real interest rate between the United States and Japan can be explained by different attitudes toward saving in the two countries.

Time endowment refers to the relationship of current wealth to expected future wealth. For example, law students often have little current wealth. They may borrow now expecting greater wealth in the future. Persons approaching retirement generally expect a decline in wealth. They tend to save. Aggregating these individual preferences determines the demand for and supply of loans.

The productivity per time period of assets acquired with borrowed funds presents a limit on how much borrowers can afford to pay for the loan. Professor Brigham gives the example of Robinson Crusoe needing a fishing season to develop an improved fishing net that will double the harvest. He would be willing to return two fish for every one that Friday gives up this season to feed Crusoe. E. BRIGHAM, *supra* note 26, at 55–56.

36. *Id.* at 58.

37. *Id.* at 61. The real interest rate component has been estimated by using historical interest rates on riskless government securities and deducting the inflation rate observed for the same time periods. Those studies show that the real interest rate component ranges from 2% to 4% per year. *But see* R. BREALEY & S. MYERS, PRINCIPLES OF CORPORATE FINANCE 118 (2d ed. 1984) (citing R. IBBOTSON & R. SINQUEFIELD, STOCKS, BONDS, BILLS AND INFLATION: THE PAST AND THE FUTURE (1982)) (the real rate on Treasury bills averaged only 0.1% from 1926 to 1981).

38. For example, long-term bond rates in December 1986 were at 7.1% for Treasury bonds, 8.5% for Aaa Corporate bonds, and 10.0% for Baa Corporate bonds. ECONOMIC REPORT, *supra*

high-risk loans.³⁹ The yield on Treasury securities is one of the lowest interest rates⁴⁰ because repayment is guaranteed and Treasury securities are traded in an active market. The prime rate,⁴¹ interest on consumer loans, and many other rates are higher than the rate of return on Treasury securities.

B. Applying the Market Rate Analysis

Courts using Collier's market rate analysis have found that the market produces many interest rates.⁴² In applying Collier's market rate analysis they have developed several definitions of the relevant market.⁴³ Although courts have not analyzed the interest rate issue by looking to the elements of interest rates, grouping the various theories according to these elements provides a framework for later discussion.

note 33, at Table B-68. Corporate borrowers had to pay more than the government, and among the corporate borrowers, those more creditworthy paid lower rates.

The risk premium is further classified as follows: First, it includes the risk of default, which means that the borrower does not pay the interest or principal in a timely manner. E. BRIGHAM, *supra* note 26, at 62. Second, a liquidation premium reflects risks that result because the debt instrument cannot be readily converted to cash, usually because the instrument is not actively traded. *Id.* at 63. This Comment refers to the combination of these risks when the term "risk premium" is used.

A third class of risk, the so-called maturity risk premium, involves the different risk premiums assigned to debt instruments according to the time to maturity. A so-called term structure results which can be traced to inflationary expectations and the risk that inflation will not be accurately forecasted. Riskless Treasury securities exhibit a term structure. E. BRIGHAM, *supra* note 26, at 63. "Inflationary expectations," as used in this Comment, are assumed to include the maturity risk premium.

39. Assuming inflationary expectations and the real rate are the same in both.

40. E. BRIGHAM, *supra* note 26, at 62.

41. The prime rate is the lowest loan rate offered by commercial banks to large, well-known corporate borrowers of the highest credit standing. D. KIDWELL & R. PETERSON, *FINANCIAL INSTITUTIONS, MARKETS AND MONEY* 176-77 (3d ed. 1987).

42. See, e.g., *In re Orosco*, 77 Bankr. 246, 253 (Bankr. N.D. Cal. 1987) (rates charged by various lenders obviously vary); *In re 360 Inns, Ltd.*, 76 Bankr. 573, 593 (Bankr. N.D. Tex. 1987) (court examined interest rates for different time periods, for residential mortgages, and for Treasury securities); see also E. BRIGHAM, *supra* note 26, at 48 (expressing the idea differently, namely that a great many different financial markets exist, each dealing with a different type of security, serving a different set of customers, or operating in a different part of the country).

43. See *infra* notes 44-58 and accompanying text. The cases cited there as representative of the various theories include other than Chapter 11 cram down cases, but the same requirement exists that the present value of deferred payments must equal the value of the creditor's claim. Courts have used methods of analysis as precedent for cases under different deferred payment provisions of the Code. See *United States v. Neal Pharmacal Co.*, 789 F.2d 1283, 1284 n.2 (8th Cir. 1986) (because sections require that a creditor be provided with the present value of its claim, the method of determining the proper interest rate is the same under each section); see also *In re Camino Real Landscape Maintenance Contractors*, 818 F.2d 1503, 1504 n.1 (9th Cir. 1987); *In re Orosco*, 77 Bankr. 246, 252-53 (Bankr. N.D. Cal. 1987); *In re Eisenbarth*, 77 Bankr. 228, 235 (Bankr. D.N.D. 1987); *In re Nite Lite Inns*, 17 Bankr. 367, 372 (Bankr. S.D. Cal. 1982).

1. Inflationary Expectations

Many courts reason that cram down interest rates should be based on market rates because market rates reflect current economic conditions.⁴⁴ Short-term Treasury bill rates are favored by those courts.⁴⁵ Courts that look to market interest rates to insure that current economic conditions are reflected reject rates that were set in the past.⁴⁶ Because the change in rates over time reflects primarily⁴⁷ the difference between past and present expectations of future inflation rates,⁴⁸ courts that choose current rates are primarily concerned with awarding the most current expectations of future inflation rates. That purpose, however, is not stated, understood, or questioned by most courts that require interest rates which reflect "current economic conditions."⁴⁹

2. The Real Interest Rate

Many courts begin their analysis with market rates, but conclude that market rates can be used only with certain adjustments. Some courts reduce market rates by a "profit" element.⁵⁰ Usually, their

44. See, e.g., *In re Connecticut Aerosols*, 42 Bankr. 706, 711 (Bankr. D. Conn. 1984) (interest must be set by reference to market conditions); *In re Nite Lite Inns*, 17 Bankr. 367, 373 (Bankr. S.D. Cal. 1982) (prime-rate based interest on delinquent federal taxes is appropriate because it is indicative of "then-existing" economic conditions).

45. *In re Connecticut Aerosols*, 42 Bankr. 706, 711 (Bankr. D. Conn. 1984); *In re Fisher*, 29 Bankr. 542, 543 (Bankr. D. Kan. 1983) (short-term Treasury bills reflect changes in our volatile economy because they are auctioned frequently); *In re Tacoma Recycling*, 23 Bankr. 547, 550 (Bankr. W.D. Wash. 1982) (Treasury bill rate is indicative of existing economic conditions). The interest (discount) rate on Treasury bills is determined weekly at public auction. C. AMMER & D. AMMER, *supra* note 25, at 473. They mature within one year. Compared to other rates, short-term Treasury bill rates are very sensitive to current inflation rates.

46. See, e.g., *In re Southern States Motor Inns*, 709 F.2d 647, 651-52 (11th Cir. 1983) (rate proposed by creditor will have been established some months earlier and often will differ from actual market rates), *cert. denied*, 465 U.S. 1022 (1984).

47. See *supra* text accompanying note 36.

48. For example, the rate of return on ten-year Treasury notes dropped from 9.2% in January 1986 to 7.1% in December 1986. Inflation, as measured by the CPI, averaged 3.8% in 1985, but dropped to 1.1% during 1986. ECONOMIC REPORT, *supra* note 33, at Tables B-59 and B-68. The experience of lower inflation rates during 1986 led to lower expected inflation rates for the future. All interest rates reflected this change in expectations with a gradual decline during 1986. *Id.* at Table B-68. But two years later, expectations of higher rates held in early 1986 appear more accurate than those held in late 1986. As of June 1, 1988, the inflation rate is at 4.8% and ten-year Treasury notes yield 7.5% per year.

49. See *infra* note 67.

50. *In re Fisher*, 29 Bankr. 542, 546 (Bankr. D. Kan. 1983) (appropriate interest rate is what a creditor would charge a nonchapter 13 debtor if a profit is removed).

decisions simply assert without explanation that profit is an inappropriate element of cram down interest rates.⁵¹

The courts which seek to eliminate the profit element do not clearly articulate what is meant by "profit." The real interest component is the profit element of the market rate.⁵² Courts that reduce market rates by the "profit" element are indirectly denying the creditor compensation for the coerced taking of the creditor's current use of funds.⁵³

3. *The Risk Premium*

Courts which are primarily concerned with determining the appropriate risk premium begin by citing Collier's method of determining the appropriate interest rate. Collier states that the appropriate rate is the market rate that the creditor would charge on a loan "to a *third party* with similar terms, duration, collateral, and *risk*."⁵⁴

51. See, e.g., *In re Cooper*, 7 Bankr. 537, 542 (Bankr. N.D. Ga. 1980) (discount rate should not generate a profit for creditor).

52. Profit is usually defined as revenue less costs. In the lending industry, revenue is equal to the total interest income. Costs include losses from default and declining purchasing power. D. PEARCE, *supra* note 22, at 357. A specific loan transaction, applying that equation, may yield a "profit" because the risks of default or inflation were overestimated. Assuming an efficient market, such "profit" cannot be realized from the aggregate of loan transactions. In the aggregate, profit will be reduced to the premium charged by lenders for giving up the productive use of funds, the real interest component.

53. If payment was guaranteed and inflationary expectations were zero, deferred payments without interest would be equivalent to immediate payment under this theory. The theory overlooks the productive capacity of capital over time.

54. 5 COLLIER ON BANKRUPTCY ¶ 1129.03, at 1129-62 (L. King 15th ed. 1979) (emphasis added). Courts have applied this definition of the appropriate market interest rate with varying emphases. Some focus on the characteristics of the deferred payments and require market rates on loans that involve the same duration, amortization rate, and type of collateral. The creditworthiness of the debtor and the usual lending practices of the creditor are generally ignored. See, e.g., *In re Landmark at Plaza Park, Ltd.*, 7 Bankr. 653, 658 (Bankr. D.N.J. 1980) (court set rate at the "high end of the range for a typical garden apartment loan").

In other courts, the debtor's characteristics receive the greatest attention. In a Ninth Circuit decision, *In re Camino Real Landscape Maintenance Contractors*, 818 F.2d 1503 (9th Cir. 1987), the court rephrased Collier's definition by holding that the debtor must pay the interest rate it would pay a commercial lender (the creditor in this case was the Internal Revenue Service ("IRS")) for a loan involving an equivalent amount, duration, default risk, and collateral. *Id.* at 1504. Rejecting the IRS's argument that it should receive the same interest that it charges on delinquent taxes, the court stated that the debtor's characteristics determined the interest rate and that the creditor's characteristics were irrelevant. *Id.* at 1506. In this consolidated case, the appeals court also reversed two of the lower court's decisions which had set the interest rate based on Treasury securities yields. The court reasoned that the debtors could not obtain credit on the same favorable terms available to the government. *Id.*; accord *In re Orosco*, 77 Bankr. 246, 252-53 (Bankr. N.D. Cal. 1987); see also *In re Hildreth*, 43 Bankr. 721, 723 (Bankr. D. Idaho 1984) (certain interest rates provide "debtors with financing at rates they could not have received otherwise and fail[] to compensate secured creditors for risks which they are forced to

Except for duration, all the factors to be compared relate to the riskiness of the loan.⁵⁵ The rate a particular creditor charges, beyond market-wide inflationary expectations and the real rate of interest charged by all lenders, is determined by that creditor's particular attitude to risk.⁵⁶ The terms and collateral underlying the loan also affect only the risk component.⁵⁷ In addition, Collier's formula expressly requires that the loan be of the same risk as the deferred payment arrangement.⁵⁸

III. THE LIMITS OF MARKET RATE ANALYSIS

Widespread acceptance of market rate analysis has shaped the nature of litigation over deferred payments. Court opinions involving these provisions frequently read like discourses in economics or corporate finance.⁵⁹ They give the appearance of scientific accuracy. However, errors in understanding or explaining loan markets and interest

take"); *In re Fi-Hi Pizza*, 40 Bankr. 258, 262 (Bankr. D. Mass. 1984) (rate of interest must reflect viability of debtor).

A third interpretation views the coerced loan from the creditor's perspective. Two variants have developed. Under the first interpretation of Collier's definition, the interest rate must be equal to the rates charged by the creditor to other borrowers of similar loans. This definition sets aside the debtor's creditworthiness and focuses on the lender's normal lending practices. *In re Monnier Bros.*, 755 F.2d 1336, 1340 n.3 (8th Cir. 1985) (contract rate was the only one in the record that was correlated with the "cost" to the creditor of the deferred payment plan); *In re Eisenbarth*, 77 Bankr. 228, 235 (Bankr. D.N.D. 1987) (court rejected rate proposed by debtor because it was not the rate that the secured creditor charged its loan customers). The second creditor-oriented method of determining the interest rate uses the cost to the creditor of replacing the amount of the claim until paid by the debtor. The interest rate therefore reflects the creditor's creditworthiness as a borrower. *In re Hardzog*, 74 Bankr. 701, 704 (Bankr. W.D. Okla. 1987) (the interest rate should reflect the actual rate the creditor must pay to obtain the replacement funds).

55. Comparing the duration of the deferred payment schedule with the term of the market loan picks up inflationary expectations for that time period.

56. The proposition does not imply that lenders are free to set interest rates. Rather, they are free to choose the level of risk they want to take by entering the appropriate loan market. E. BRIGHAM, *supra* note 26, at 57. See, e.g., *In re Fi-Hi Pizza*, 40 Bankr. 258, 267 (Bankr. D. Mass. 1984) (citing J. WESTON & E. BRIGHAM, *MANAGERIAL FINANCE* 242-43 (5th ed. 1975)) (investment in higher yielding instruments implies willingness to take greater risk).

57. D. KIDWELL & R. PETERSON, *supra* note 41, at 180-81 (banks, in assigning a default risk premium to a customer, consider the borrower's character, cash flow, wealth, and collateral).

58. 5 COLLIER ON BANKRUPTCY ¶ 1129.03, at 1129-62 (L. King 15th ed. 1979). Collier does not mention the debtor in the formula. Instead, the loan is to a "third party." At the same time, the formula requires equal risk. This necessarily entails consideration of the debtor's creditworthiness. In fact, many courts that base their analysis on Collier emphasize the debtor's creditworthiness.

59. See, e.g., *In re Arnold*, 80 Bankr. 806, 809 (Bankr. M.D. La. 1987) (explaining that aspects of risk are not limited to default, but include liquidity risk and inflationary expectations).

rates are common.⁶⁰ Theories are misapplied in factually different contexts.⁶¹ Unguided judgments about the proper risk premium are often presented as the inevitable result of market rate analysis.

A better treatment of the interest rate issue is achieved by referring to the purposes of business reorganization law. Market rates have limited usefulness, supplying only the inflationary expectation component and the real interest rate component of an appropriate interest rate. The proper risk premium has to be chosen by the court because a market for this type of loan does not exist. To make the choice, courts should define the relative rights of debtors and creditors. Doing so will give debtors and creditors better information on which to base their decisions when faced with a Chapter 11 proceeding. As a result, negotiated settlements will be more likely and litigation more efficient.

Market interest rates are relevant in determining the present value of a claim. Courts must recognize the limits of the market rate approach, however. Its limits are best understood by examining each component of the interest rate separately. This method of analysis shows that market rates provide a useful measure of inflationary expectations and of the real interest rate, but are useless in determining an appropriate risk premium.

A. Inflationary Expectations

Many courts hold that market rates are appropriate because they are "current." The only current economic conditions reflected in market interest rates are inflationary expectations. Courts which use this standard imply that the creditor must be compensated for the expected loss of purchasing power.⁶² Neither the statute nor the legislative history expressly refers to compensation for loss of purchasing power. But the terms "present value" and "time-value" of money appear frequently. These are terms of art⁶³ which should derive their

60. See, e.g., *In re Bay Area Servs.*, 26 Bankr. 811, 814 (Bankr. M.D. Fla. 1982) (court ordered interest rate calculated by adding 10% for inflation to the prime rate). Because the prime rate already includes inflationary expectations, the creditor was compensated twice for the loss of purchasing power.

61. Compare *In re Fi-Hi Pizza*, 40 Bankr. 258, 266 (Bankr. D. Mass. 1984) (court reasoned that taxing authority was not entitled to a profit and transaction cost because it was not a commercial lender) with *In re Klein*, 10 Bankr. 657, 661 (Bankr. E.D.N.Y. 1981) and *In re Lum*, 1 Bankr. 186, 188 (Bankr. E.D. Tenn. 1979) ("profit" was also disallowed although creditors were commercial lenders).

62. These courts usually do not discuss the goal of compensating the creditor for the loss of purchasing power. But see *In re Fi-Hi Pizza*, 40 Bankr. 258, 262 (Bankr. D. Mass. 1984) (court considered whether inflation rate would be sufficient interest rate and concluded that creditors at a minimum should be compensated for the loss of purchasing power).

63. *Id.* at 261 (present value is a term of art used by the economic and financial communities).

meaning from the art that uses them:⁶⁴ economics and corporate finance. These disciplines consider inflationary expectations an important component of interest rates.⁶⁵ Courts could conclude that interest on deferred payments has to include the right measure of inflationary expectations⁶⁶ and that market rates reflect that measure.

Many courts that insist on current rates, however, ignore the time period over which the deferred payments are to be made under the plan.⁶⁷ If loss of purchasing power is to be gauged accurately, the market interest rates should match the deferred payment schedule with respect to time to maturity.⁶⁸ Superficial applications of the market rate approach have led courts to use the wrong market rate. These courts apparently do not understand what role interest rates play in compensating creditors for giving up the current use of funds. They postulate that interest rates have to reflect "current economic conditions," without understanding the requirement and without explaining how the Code or policy considerations justify it.

B. *The Real Interest Rate*

The market rate approach has led to other superficial analyses. Courts have concluded that interest rates should not include a "profit" element. The meaning of that assertion is unclear.⁶⁹ Courts may be referring to the real interest rate, any excess of the market rate over the contract interest rate, or to a double charge by the creditor for the risk of default.⁷⁰

64. 1 BLACKSTONE'S COMMENTARIES *59.

65. E. BRIGHAM, *supra* note 26, at 61 (inflation has a major impact on interest rates).

66. Inflation rates were relatively high when the Code was being considered by both Houses and when it finally was passed. In the five-year period 1969 through 1973, inflation averaged 5% per year. During the five-year period immediately preceding passage of the Code, 1974 through 1978, inflation averaged 8% per year. ECONOMIC REPORT, *supra* note 33, at Table B-59 (rates calculated from data presented in Table B-59). At that time, the most obvious difference between the present and future value of a claim was the intervening loss of purchasing power.

67. See, e.g., *In re Connecticut Aerosols*, 42 Bankr. 706 (Bankr. D. Conn. 1984) (tax claim to be paid over six years, but court set rate based on average accepted auction price for the last auction of 52-week Treasury bills).

68. For example, three-month Treasury bills yielded 5.5% per year interest in December 1986 while ten-year Treasury notes yielded 7.1%. ECONOMIC REPORT, *supra* note 33, at Table B-68. Higher than current inflation rates were expected over the next ten years. If payments under a plan are due ten years from now, the ten-year rate is appropriate. To take advantage of the information that market rates provide, the maturity dates of the market debt instruments must match the payment dates under the plan.

69. Cf. *In re Arnold*, 80 Bankr. 806, 809 (Bankr. M.D. La. 1987) (criticizing statement in a law review article that interest rate on government securities does not include a profit element, and is therefore appropriate in cram down, as a "bold, and bald," assumption).

70. The two latter interpretations only apply when the case involves a pre-petition loan agreement.

The interest rate on deferred payments should include a real interest component. Choices or opportunities offered by current availability of money have inherent value. To induce the holder of money to give up that value, a price has to be paid. The real interest rate is established as the market price at which individuals are willing to exchange current for future choices or opportunities offered by holding money.⁷¹ Since most courts agree that deferred payments require some interest payment to compensate the creditor for the loss of use of funds, the appropriate rate should include the real interest component.

Courts sometimes speak of prohibiting a "profit" element in the interest rate to prevent creditors from profiting as a direct result of the debtor's Chapter 11 proceeding. The creditor could "profit" if the rate used at plan confirmation is higher than the contract rate of a pre-petition loan agreement.⁷² Had the debtor fulfilled the contract, the creditor would have received a lower interest rate.

A court facing this situation should begin by articulating the problem. Articulating the problem will prevent improper application of the rationale to claims not involving pre-petition contracts, such as tax claims. The next step is to acknowledge competing creditor and debtor positions on the relevance of the contract interest rate.⁷³ The court may, for example, decide in a particular case that the higher market rate would prevent the debtor's reorganization. If policy considerations underlying the Code indicate that the debtor should reorganize, the court can conclude that the contract rate represents a ceiling for interest on deferred payments.

Pre-petition contract interest rates include a default risk premium. One of the risks the lender anticipated and insured against is that the borrower may seek protection under Chapter 11. According to this

71. See *supra* text accompanying notes 34-37.

72. If the reorganization plan maintains other features of the loan agreement, such as duration and amortization, the creditor can reap a windfall from the reorganization that provides for deferred payments at market interest rates. The reverse is also true. The debtor "profits" when market rates are lower than the contract rate. See, e.g., *In re Loveridge Mach. & Tool Co.*, 36 Bankr. 159 (Bankr. D. Utah 1983) (court required contract rate on twenty-month-old loan to avoid giving windfall to debtor).

73. For example, the creditor that wants the higher market rate will insist that the contract rate was based on the assumption that it could foreclose on the collateral in case of default. Had the creditor been allowed to foreclose, it could have invested the foreclosure proceeds at the higher market rate. According to this argument, the creditor is not receiving an extraordinary profit; the court is only protecting the creditor's rights under state law if it awarded market rates.

Proponents of the contract rate as a ceiling can point out that the bargain may have included foreclosure rights, but any loan is foremost a contract where the creditor expects to receive the bargained-for interest rate. If the debtor's plan proposes to repay the creditor according to the terms of the loan agreement, the creditor still receives what it bargained for.

interpretation of the “no profit” rationale, the creditor now can be treated less favorably than a lender in the market making an original loan because it was already compensated for the risk that has materialized.

This rationale is both appealing and far reaching. Taken to the extreme, it would support the argument that the creditor anticipated losing its entire claim in Chapter 11, charged an appropriate risk premium under the contract, and therefore should lose the entire claim. If courts took such a position, market rates would skyrocket and destroy an efficient credit economy. Thus, it could not be reconciled with the purposes of the bankruptcy system. But a carefully chosen position, one which recognizes that market rates reflect risks however defined by the legal system, will insure that the bankruptcy system supports efficient financial markets. That position would require choosing an interest rate low enough to promote successful reorganization, but not so low as to raise market rates to such an extent that the loan markets contract.

C. *The Risk Premium*

Allowing the debtor to pay claims over time involves some risk that the debtor will never make the deferred payments.⁷⁴ Market rate analysis cannot tell courts who should bear that risk in a Chapter 11 proceeding. Courts have developed several theories in a futile effort to fix the proper risk premium. Each defines the relevant market-equivalent transaction differently and ignores the basic fact that the issue of the proper risk premium arises in a Chapter 11 proceeding.⁷⁵

These different theories can be criticized in two ways. First, these theories focus the litigants’ arguments on market transactions, while courts base their decisions on interpretations of the debtors’ and creditors’ rights in a Chapter 11 proceeding. Second, despite the existence of so many different theories, courts have not acknowledged that market rate analysis leaves much room for discretion in determining the proper risk premium.

Market rates only provide an accurate measure of inflationary expectations and the real interest component. They do not determine

74. Some courts hold that the risk of nonpayment is minimal because the confirmed plan must be feasible. *E.g.*, *In re Fisher*, 29 Bankr. 542, 544–45 (Bankr. D. Kan. 1983). Other courts cite the high failure rate of confirmed plans as an indication of the debtor’s riskiness. *E.g.*, *In re Fi-Hi Pizza*, 40 Bankr. 258, 266 (Bankr. D. Mass. 1984). In *United States v. Neal Pharmacal Co.*, 789 F.2d 1283, 1288 (8th Cir. 1986), the court found that reorganized debtors are at least as likely to default as nonreorganizing corporate debtors.

75. *See supra* note 54.

the risk premium appropriate in Chapter 11. Courts, by ignoring this fact, have become involved in fruitless debate and a waste of judicial resources. Many courts, for example, state that the appropriate risk premium should consist of the market's assessment of the risk involved in lending to one with the particular debtor's characteristics. Some creditors have taken this requirement literally, insisting that deferred payments, regardless of the proposed interest rate, would never be adequate compensation for giving up a present claim to the collateral.⁷⁶ Debtors have claimed that this would set the interest rate so high that reorganization would be impossible.⁷⁷ Thus, by interpreting the courts' theory literally, both debtor and creditor can claim that the market-equivalent transaction would not take place.⁷⁸

The real argument between debtor and creditor is not about economic theory and loan markets but about their rights. Creditors either believe the debtor should liquidate or that they are entitled to a greater share of the debtor's future income. Debtors believe that a higher interest rate will give the creditor more than the value of its claim, to

76. *E.g.*, *In re Orosco*, 77 Bankr. 246, 254 (Bankr. N.D. Cal. 1987) (secured creditor argued that debtor was not a qualified borrower under its lending practices because of the debtor's default record.); *In re Wolf*, 61 Bankr. 1010, 1012 (Bankr. N.D. Iowa 1986) (creditors offered bank officials' testimony that no loans at 100% of value would be made); *In re Nite Lite Inns*, 17 Bankr. 367, 372 (Bankr. S.D. Cal. 1982) (payment over time not equivalent to immediate payment because taxes on payments are due immediately). In *Nite Lite Inns*, the creditor also argued that it should be able to sell the debtor's note and receive the value of its claim although the note would be discounted by 40%-50%. *Id.* at 373; *In re Landmark at Plaza Park Ltd.*, 7 Bankr. 653, 657 (Bankr. D.N.J. 1980) (regardless of the interest rate offered, the value of the payment stream will be less than the value of the property that secures the claim because an investor would prefer the property to debtor's promise to pay).

77. *In re Fi-Hi Pizza*, 40 Bankr. 258, 270 (Bankr. D. Mass. 1984) (if rate has to be based on hypothetical transaction by a distressed small business, debtor could not obtain financing at any price).

78. The creditor-oriented interpretation of Collier's definition of the appropriate interest rate has been similarly attacked. In response to the court's requirement that the interest rate equal the rate charged by the creditor on similar loans, creditors have argued that they do not make similar loans. They simply do not lend to borrowers that are bad credit risks. *In re 360 Inns, Ltd.*, 76 Bankr. 573, 591 (Bankr. N.D. Tex. 1987) (creditor offered testimony that it would not make loans of the kind proposed under the plan). Banks rate each customer's credit risk and demand higher rates as risk of default increases. At some point, banks refuse credit. D. KIDWELL & R. PETERSON, *supra* note 41, at 180-82.

Courts have also rejected the theory, reasoning that interest rates would depend on the creditor's willingness to take risks. Different rates would be required for different creditors under the same plan. *In re Arnold*, 80 Bankr. 806, 811 (Bankr. M.D. La. 1987); *In re Benford*, 14 Bankr. 157, 160 (Bankr. W.D. Ky. 1981).

The replacement cost theory has been criticized as well. Creditors point out that their good credit ratings allow them to borrow at lower rates, but they still have to look to the debtor to pay off the replacement loan. Under this theory, creditors clearly bear the risk of nonpayment. *In re Hardzog*, 74 Bankr. 701, 704 (Bankr. W.D. Okla. 1987).

the detriment of other creditors and equity holders, and that it will threaten a successful reorganization.

These arguments, rather than expert testimony on market interest rates, need to be developed by the parties and then dealt with directly by the court.⁷⁹ A creditor could argue, for example, that the debtor's plan is barely feasible. If the plan can be confirmed at all, the creditor should be solidly protected. In setting the risk premium, the court could agree with the creditor and find that only a very high interest rate will make the value of the deferred payments equal to the value of the creditor's claim. The court's own estimate, in light of the purposes to be served by reorganization law, is more relevant than market risk premiums.⁸⁰

IV. AN ALTERNATIVE PURPOSE-ORIENTED ANALYSIS

Any direct analysis of the interest rate issue needs to incorporate systematically the purposes of reorganization law. The courts must answer two questions: First, whether the interest rate should be uniform⁸¹ or case-specific⁸² in all cram down cases, and second, whether

79. Most courts are fully aware that creditors and debtors are fighting over assets and income and not over appropriate market interest rates. Many courts in fact weigh the interests of creditors and debtor, and then decide on an "equitable" interest rate. *See, e.g., In re 360 Inns, Ltd.*, 76 Bankr. 573, 593 (Bankr. N.D. Tex. 1987) (because debtor was solvent and intended to let equity holders participate, proposed rate was too low); *In re Wolf*, 61 Bankr. 1010, 1012 (Bankr. N.D. Iowa 1986) (court found that "[o]n balance, I conclude that an interest rate of 11% is appropriate and will accord the objecting creditors fair and equitable treatment within the meaning and spirit of [the cram down provisions.]") Unfortunately, the courts do not articulate the factors and weight of the interests to be balanced, leaving creditors and debtors without guidance. *Cf. COMMISSION REPORT, supra* note 15, at 74 (bankruptcy system should supply information to guide conduct of participants in the credit economy).

80. If the court finds that the need to protect the creditor outweighs the interests of unsecured creditors and the debtor in a successful reorganization, it can reject all rates as too low, giving the secured creditor additional bargaining power. If such a high rate ends up making reorganization infeasible, it means that the cram down provisions have functioned properly to protect the creditor.

81. *In re Fi-Hi Pizza*, 40 Bankr. 258, 272 (Bankr. D. Mass. 1984) (announcing intent to use the rate on delinquent federal taxes with a 2.5% adjustment in all cases unless special circumstances require different adjustment); *In re Fisher*, 29 Bankr. 542, 552 (Bankr. D. Kan. 1983) (court will use 52-week Treasury bill rate plus 1% risk factor in all pending and future Chapter 13 cases); *cf. In re Loveridge Machine & Tool Co.*, 36 Bankr. 159, 168 (Bankr. D. Utah 1983) (Chapter 13 cases tend to deal with the interest rate en masse, while Chapter 11 has the fair and equitable requirement).

82. *E.g., In re Camino Real Landscape Maintenance Contractors*, 818 F.2d 1503, 1508 (9th Cir. 1987); *United States v. Neal Pharmacal Co.*, 789 F.2d 1283, 1289 (8th Cir. 1986) (despite savings of money and time achieved by a uniform rate, "language of section 1129(a)(9)(C) . . . clearly compels . . . determination . . . on a case by case basis"); *In re Southern States Motor Inns*, 709 F.2d 647 (11th Cir. 1983) (rejecting bankruptcy court's decision to use the same rate in all cases), *cert. denied*, 465 U.S. 1022 (1984).

the rate should be relatively high or low.⁸³ Examining the benefits and drawbacks of each choice will insure systematic analysis of debtor and creditor rights in Chapter 11, of the proceedings' efficiency, and of the strategic responses that can be expected of debtors and creditors. Ultimately, a court must balance these considerations to determine the appropriate interest rate.⁸⁴

A. Uniform or Case-Specific Interest Rates

Using either a uniform or case-specific interest rate represents a fundamental judgment about the relative rights of creditors and debtors. A uniform rate would turn the "fair and equitable" requirement of cram down into a threshold test. Regardless of the circumstances, a plan would have to include a specific pre-determined interest rate. Thus, a uniform rate would in effect amount to a pre-determination that the deferred payments have a present value equal to the value of the claim.

Knowing in advance which interest rate will pass the cram down test would make cram down proceedings more efficient. With a uniform rate, debtors and creditors could more easily assess whether reorganization is an option or whether the debtor should liquidate.⁸⁵ Because the parties would know what interest rate the plan must include, a uniform rate also would save hearings and expensive expert testimony on the interest rate question. Finally, it would insure that issues already decided by the court, such as the good faith of the debtor or feasibility of the plan, would not be reargued indirectly over the interest rate issue.⁸⁶

A uniform rate, however, would preclude a case-by-case determination of the appropriate rate. A plan extremely likely to succeed would have to propose the same interest rate as one that is barely feasible. A

83. A riskless rate is a low interest rate. All interest rates that include a risk premium are treated here as relatively high rates.

84. The following discussion assumes that the court uses a riskless market rate such as Treasury securities of the appropriate maturity as a base rate. It has concluded that the creditor's purchasing power has to be protected and that the creditor has to be compensated for giving up the use of funds. The court now examines whether it should add the same or a different risk premium in each Chapter 11 case, and whether that premium, either fixed or flexible, should be relatively high or low.

85. *In re Fi-Hi Pizza*, 40 Bankr. 258, 271 (Bankr. D. Mass. 1984) (using the interest rate applicable to delinquent federal taxes, investors can have relative certainty in working toward reorganization).

86. *E.g., In re Monnier Bros.*, 755 F.2d 1336, 1340 (8th Cir. 1985) (contentions that the plan is too risky must be addressed in terms of the cram down standards or the feasibility requirement). *But see In re Landmark at Plaza Park, Ltd.*, 7 Bankr. 653, 656 (Bankr. D.N.J. 1980) (court recognized that interest rate would impact feasibility).

creditor likely to benefit from the reorganization would receive the same interest rate as one likely only to be hurt by delay. Debtors could use Chapter 11 to obtain lower interest rates on their loans or they may have to pay higher than contract rates. The interest rate would be the same whether or not unsecured claims of employees and trade creditors could be paid.

Conversely, a case-specific rate would allow the court to take into account the differences among Chapter 11 cases. Cram down requires a fair and equitable plan. Equality of the value of deferred payments and the claim represents one aspect of a plan's fairness and equity. Because a court has to judge what level of interest insures such equality, it could extend the "fair and equitable" test to that judgment. A court could, therefore, require a lower rate when the plan is solid and likely to succeed. A higher rate would be appropriate when the debtor was suspected of questionable objectives such as refinancing at lower market rates or stalling inevitable liquidation.

The efficiency of predictable interest rates lost by this approach, however, far exceeds the gain in fairness.⁸⁷ Efficient cram down proceedings will also result in more efficient loan markets.⁸⁸ The loan market passes the costs currently associated with the inefficiencies and uncertainties of cram down proceedings on to the borrower in the form of higher interest rates. Other things being equal, uniform rates reflecting increased certainty over creditor and debtor rights in cram down will result in lower rates.

Fairness also prevails with predictable rates. Application of a uniform rate serves as notice to borrowers and lenders⁸⁹ of their respective rights, should the debtor file for protection under Chapter 11. The predictable cram down rate will be reflected in the contract rate. A fair result is achieved when the court fulfills the parties' expectations.

B. High or Low Interest Rates

If courts are willing to take into account the market response, the problem of the appropriate risk premium can be easily solved. The

87. Cf. COMMISSION REPORT, *supra* note 15, at 82 (although bankruptcy has long been regarded as an equity and not a legal process, the amount of decision-making should be minimized to save costs).

88. E. BRIGHAM, *supra* note 26, at 49 (economy depends on efficient financial markets; employment, productivity, and standard of living would be lower if financial markets were not efficient).

89. Judgment lien creditors and holders of tax claims who do not negotiate contract interest rates cannot benefit from this notice.

market will adjust to any consistent risk premium chosen by the courts. Courts only need to consider whether relatively high or low rates further Chapter 11's purposes of encouraging fair, negotiated reorganization plans that give debtors a chance to survive while protecting the interests of creditors.

The riskless interest rate, a relatively low rate, would best advance these objectives. The creditor still receives protection from the loss of purchasing power and also receives a real rate of interest. Requiring creditors to forego the risk premium involves only a minor loss of rights. Creditors would recoup the loss by charging higher interest rates in general, but market interest rates will not increase so significantly as to impair the loan market. Lower interest rates will also make more reorganization plans feasible and successful.

A uniform, low cram down interest rate would affect the relative bargaining power of creditor and debtor in plan negotiations. Most likely, debtors would offer exactly the pre-determined interest rate. Creditors cannot threaten to reject the plan with the hope that the court will require a higher rate in cram down. Although the interest on deferred payments would be fixed, debtor and creditor could still negotiate the value of the claim.⁹⁰ Known interest rates would narrow the areas of possible dispute sufficiently to make negotiated settlements more likely. Keeping negotiations focused on fewer issues is more likely to lead to confirmed plans without expensive resort to cram down.

Using uniform, riskless interest rates in cram down of secured creditors will also provide the balance of bargaining power that is now lacking. A secured creditor is usually the sole member of the class and, therefore, has veto power over any proposed plan. The more uncertain the outcome and the higher the expense of cram down, the greater the risk that the power will be exercised. Case-by-case analysis, which often concludes that the debtor has to pay higher than proposed interest rates, gives secured creditors too much power.

V. CONCLUSION

Using Treasury securities yields of the appropriate maturity as cram down interest rates in all cases would be both efficient and fair for several reasons. First, these riskless, relatively low rates would increase the chance of successful reorganization, benefitting unsecured creditors and equity holders. Second, creditors would be compensated

90. *Axe, supra* note 17, at 448 (question of valuation is resolved through negotiations in light of uncertain court decisions).

for the loss of purchasing power and for the loss of use of funds. Many creditors could achieve additional protection by adjusting contract interest rates according to this clear cram down rule. Third, a clear standard would promote negotiated agreements between debtor and creditor. Certainty of outcome if the dispute is litigated would eliminate the dispute in most cases. The threat of the secured creditor forcing cram down would be less powerful because the litigation would be less expensive. This improved balance of bargaining power between debtor and creditor also would encourage negotiated settlement.

A case-specific market interest rate that reflects the characteristics of the debtor, the creditor, or the loan is a costly requirement in Chapter 11 cram down. Costs are not limited to the expense of expert testimony to establish market interest rates. They also include the cost of increased litigation and loss of private control over outcomes as a result of unpredictable court decisions. On balance, a uniform, predictable interest rate better serves the purposes of the bankruptcy system.

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